The Economic Debate 2024

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Submission to the Senate Inquiry into

Treasury Laws Amendment (Reserve Bank Reforms) Bill 2023 (Provisions)

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- ***The Australian Government needs to reclaim control of economic policy and use its Constitutional Powers to manage the economy in the interest of the Australian people.***

Abstract

This paper seriously discusses outcomes of structural reform of the Australian economy post 1983. The outcomes of structural reforms appear poorly understood by the media, political class, industry leaders, academia, and other commentators. The social fabric of society changed as sectoral power and influence was redistributed through structural reform. Asset inflation has emerged and established a class system in which a well-paid class prosper whilst a poorer underclass seeks help from charities. The term asset inflation though appears expunged from economic nomenclature.

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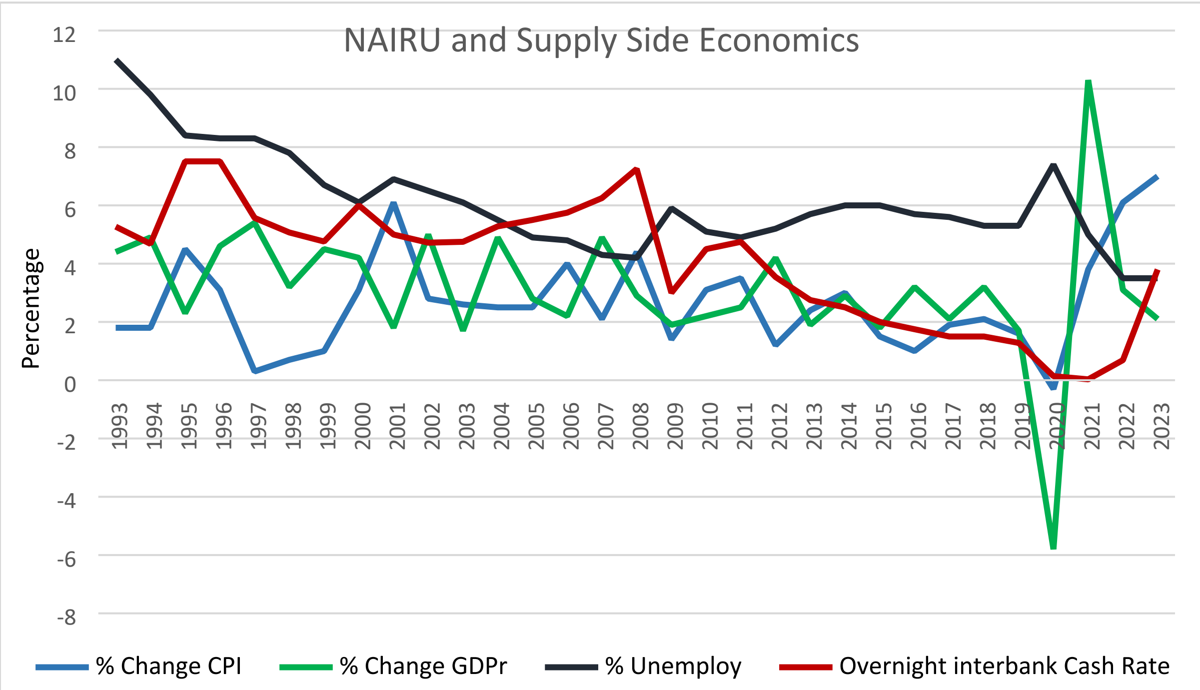
"Neoclassical heritage still has great influence-------. Its latter-day practitioners take refuge in building up more and more elaborate mathematical manipulations and get more and more annoyed at anyone asking them what it is they are supposed to be manipulating".

Joan Robinson[i]

1 Monetary Policy Theoretical Discussion

Chart 1



Compiled from RBA Statistical Tables online.

Monetary policy in Australia has come under criticism over recent months. As portrayed in the Chart 1 above, monetary policy appears impotent and unable to provide stability to an economy experiencing long term decline. Whilst, monetary policy has followed the CPI curve closely, the GDPr curve indicates the underlying economy has been in long term structural decline since the GFC in 2007. Economic dislocation over COVID shows that monetary policy offered no answer until inflation skyrockets. All it could offer then was to raise interest rates which would compound economic dislocation from COVID.

Post Covid, rising inflation caused by a combination of income support programs and international supply dislocations awakened monetary policy; but being a blunt instrument monetary policy came out of its slumber only to raise interest rates at a time when the underlying economy was experiencing its worst downturn since the Great Depression. This short discussion attempts to explain why monetary policy and economic policy in general has become impotent and cannot meet the needs of the modern Australian economy.

The story begins with the election of the Labor Government in 1983 and adoption of Thatcherism and supply side economics. In December 1983, the newly elected Labor Treasurer deregulated the Australian Currency which then became the responsibility of the Reserve Bank of Australia. In 1985, monetary targeting was abandoned as monetary flows under the deregulated exchange rate had destabilised the domestic demand for money function. In 1988, the RBA assumed the money supply endogenous which meant bank credit determined the domestic money supply.

Ms = BR + DCE

Ms = Money Supply

BR = Bank Reserves

DCE = Domestic Credit Expansion

Ms=Md in equilibrium

In February 1990, the RBA announced the Cash Rate would become the official monetary policy instrument. The official policy instrument for monetary policy then became the domestic overnight bank rate for interbank transactions which sets the supply price of domestic credit. In the equation above, as monetary policy sets the price of bank credit to manage monetary policy is then transmitted through the banking system to influence industry demand for credit. Industry demand for credit then flows back to the demand for labour. It is in the labour market that the transmission mechanism finally comes to rest as the actual unemployment rate adjusts to equate with NAIRU. So structured, monetary policy becomes a supply side policy arm.

In 1993, the RBA announced it would target inflationary expectations within a proposed 2% - 3% target range over a set period of time. The level of inflation was to be maintained at the equilibrium aggregate output level at which the actual rate of unemployment equalled the Non- Accelerating Inflation Rate of

Unemployment or NAIRU[ii]. This measure of unemployment is sometimes referred to as the natural rate of unemployment NRU. However, there is a technical difference. NRU refers to an econometric model in which all markets clear under pure competition. NAIRU, however, assumes some market imperfection; but markets still clear. Originally the terms were used to distinguish between employment in the USA and employment within the European economic system.

The real problem with monetary policy lies not in its definitions of the labour market; but, in its underlying economic philosophy. The terms NAIRU and inflation targeting are directly identifiable with Friedmans inflation augmented Phillips Curve[iii]. Consequently, monetarism is clearly a dominant economic philosophy underwriting Australian monetary policy. The other economic philosophy which underwrites econometric modelling is neoclassical general equilibrium modelling which emerged in Australia in 1972[iv]. Combined, these two economic philosophies underwrite both the New Neoclassical Synthesis and the New Keynesian Synthesis. The difference between the two synthesis revolves around a New Keynesian Synthesis additional assumption of monopolistic competition in its DSGE model. In this discussion the synthesis will be simply referred to as the supply side monetarist synthesis

Significant change in monetary policy emerged with the announcement in 1988 that the RBA recognised the money supply being endogenous. Whilst this was consistent with global monetarism, the assumption of an endogenous money supply officially moved applied monetary policy from post War demand management to supply management of the monetary policy arm. Supply side monetary policy dates back the 1920's and R.G. Hawtrey's monetary trade cycle theory. It is a theory from the forgotten economic philosophies of Classical, Neoclassical, Monetarism, and Austrian economics none of which had anything to offer during the dislocation of the Great Depression. In 1936 Keynes released his *General Theory of Employment, Interest and Money* in which monetary policy became a demand side policy arm.

In February 1990, the RBA announced that the Cash Rate would be the official policy instrument. This announcement identified the supply side monetary policy instrument that would set the price of bank credit. From that point onwards, if a demand side problem arose, then monetary policy had to firstly adjust the supply side price of credit consistent with monetary policy stance. Secondly, policy stance must work its way through the transmission mechanism of the banking system to influence the demand for credit. Thirdly, by influencing the price of credit to industry, aggregate demand response influenced the demand for labour, and hence, the unemployment rate. This of course is a convoluted inverted application of early nineteenth century Say's Law of Markets interpreted by Professor Pigou in 1926[v].

As monetary policy is concerned with inflation measured in a basket of goods, an unanswered question becomes: what happens to prices not measured in the CPI basket of goods particularly in asset markets?

Negative gearing provides an attractive taxation policy option for two obvious groups: high income earners, and lowly encumbered middle-income groups. As interest rates rise, these groups can utilise negative gearing taxation advantage to minimise tax imposts whilst building an asset wealth portfolio. The demand for bank credit to fund asset purchases expands the DCE component of the domestic money supply. As DCE expands the money supply, asset inflation becomes the unrecognised outcome of supply side monetary policy. In a modern densely populated urbanised economy, home ownership for rental income becomes a prime asset target.

2 Asset Price Inflation

"Since wealth effects are a key element of monetary transmission mechanism, any cooling of economic activity required the asset price inflation be brought under control".

Adrian Blundell- Wignell, and Michelle Bullock[vi]

Asset price inflation can be demonstrated mathematically using the former definition of the money supply. Assume in equilibrium that the money supply equals money demanded, then Ms = Md :

If Md = R+DCE

Then in equilibrium

Ms = R + DCE

Consequently, any increase in the demand for money, however triggered, generates a corresponding increase in the supply of money. The accommodating variable becomes DCE. Theoretically, asset price inflation is directly explainable through Milton Friedmans Modern Quantity Theory which is explained in David Laidler's 1977 book *The Demand For Money*[vii].

$$Md = f(W, r - 1/r\ dr/dt, 1/P\ dP/dt, h)P$$

Md = demand for money

W = Wealth

r= rate of interest

h= ratio of human to non-human wealth

P= price level

As the real sector is not recognised in the Modern Quantity Theory, the wealth effect becomes the transmission mechanism through an inverted Pigou effect i.e. real value of money and wealth become devalued as nominal prices rise. Implicitly, neoclassical underconsumption theory completes the process. Theoretically, as asset inflation raises nominal wealth, consumption expenditure is stimulated through the wealth effect. For example, rising nominal wealth is borrowed against to stimulate consumption expenditure which flows on to investment expenditure, and employment.

In the real world, the flow on from asset inflation affects low-income groups through rental increases and rising mortgage repayments. Low-income groups face financial pressure as income levels struggle to manage not only home mortgages and rental payments; but also rising goods prices both within and beyond the CPI basket of consumer goods.

This can be understood if it is assumed that in equilibrium Ms=Md, then

Then in equilibrium, the Quantity Theory of Money supply of money can be rewritten:

$$Ms == f(W, r - 1/r\ dr/dt, 1/P\ dP/dt, h)P$$

Viewing the Modern Quantity Theory from the money supply perspective, W is an obvious transmission mechanism. Interest rates become a minor transmission mechanism working from supply side credit pricing to demand side labour market disequilibrium to address any deviation of actual unemployment from NAIRU.

It can be inferred that as monetary policy stance changed, then W (wealth) would dominate the transmission mechanism. Negative gearing would encourage medium to high income earners to increase wealth portfolios whilst low income to low middle income earners simply paid higher rental prices as home investors raised rents to cover increasing interest impost from expanding portfolios. In other words, a two-class economic system evolves comprising firstly medium to high income earners (wealth holders), and secondly, low income to low middle income groups experiences declining disposable incomes.

A significant contribution to the current crisis of homelessness can be attributed to supply side monetary policy generating asset inflation in the residential home market. Rising demand for charity and homelessness becomes the public face of applied supply side/monetarist synthesis policies.

3 Asset Inflation and the Social Fabric

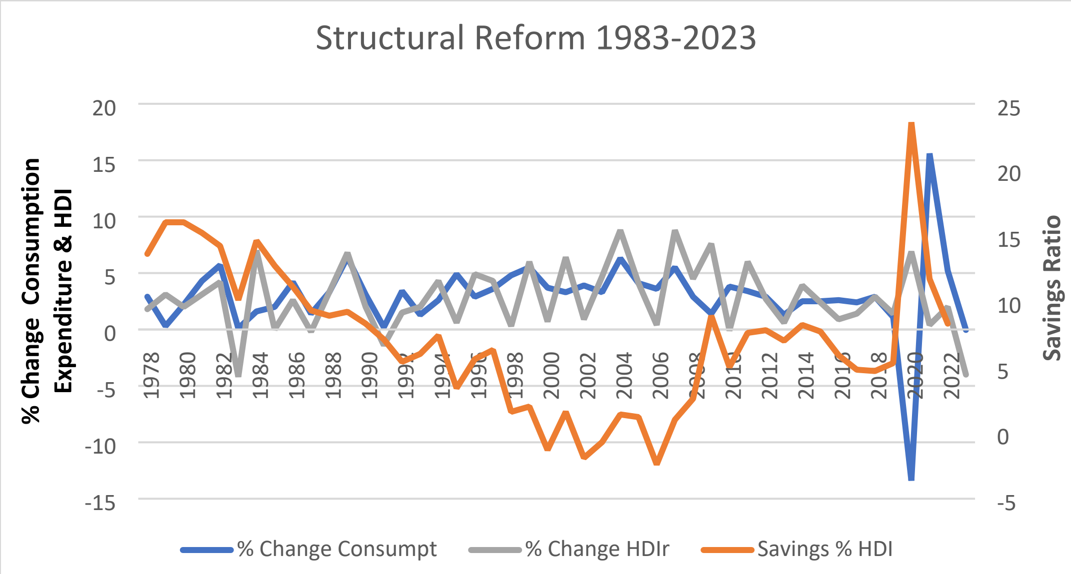
In the real world, supply side monetary policy directed to bringing actual unemployment equal to NAIRU is devoid of any semblance of morality. As Joan Robinson[viii] says, "*It is not a correct deduction from the Principles of Economics that enlightened self-interest always operates in the public interest".* In the twenty first century, supply side economics has produced a two-class system comprising an asset wealthy class and a lower income underclass.

Unchecked, asset inflation destroys the social fabric of society by structuring a wealth-based class system. The favoured group build wealth whilst the remainder endure declining living standards as monetary policy does its work. Resentment within the lower income strata would be expected to increase social discontent and fuel a rising crime rate. Moreover, youth resentment would be expected to be high underwriting youth rebellion and rising crime levels. Resentment would be expected also to fuel activism in other social policy areas of society as the underclass seek a political voice to express discontent with the failings of the economic system.

4 Empirical Analysis

Chart 2 below provides empirical evidence of the failure of supply side economics. The transition to supply side/ monetarist synthesis is readily identifiable post 1988 when the savings ratio collapses. The other two curves show empirically what happened to Household Disposable Income as a percentage of GDP and the percentage change in consumption expenditure as a percentage of GDP.

Chart 2



Compiled from RBA Statistical Tables online Table H2 Demand and Income

Supply side monetary policy began in 1988 when the RBA announced it was assuming an endogenous money supply. In February 1990, supply side monetary policy became operational with the announcement that the Cash rate would be the monetary policy instrument.

Look closely at the observed variables. The behaviour of the Savings curve holds the key. In 1984 the savings ratio was 14.6% of household disposable income.in 1988 when monetary policy moved to supply management of bank credit, the savings ratio had fallen to 8.6 %. It bottoms out in 2006 at-2.4%. the GFC in 2007 forced a change in household behaviour and the savings ratio begins to rise and peak at 8.9% in 2009. By 2019 the Savings Ratio stood at 5.3%. The combination of household support programs and uncertainty lifts the household savings ratio to a peak of 24% in 2020. By 2023, the savings ratio had collapsed to 2.8%.

Percentage change in Household Disposable Income curve is 7.1% in 1984. The curve falls to 3.3% in 1988 and continues to bottom out at 0.4% in 2006. By 2010, the rate of change in HDI curve falls to 0.1%. By 2018, percentage change in household disposable income stood at 2.9%. The impact of income support programs is clearly visible in the rate of change in household income rising to 6.7% in 2020. However, by 2023, household income contracts -2.6%; and the RBA wants to raise interest rates!

The other important curve is the percentage change in consumption. In 1984, consumption expenditure was growing at the rate of 1.6%. By 1988, growth in consumption expenditure had risen to 3.3%. By 2006 expenditure of consumption rose 3.6%; but the onset of the GFC induced a reduction in consumption growth to 1.4%. Just prior to Covid in 2018, growth in consumption expenditure had risen 5%. However, COVID changed consumer behaviour. In 2020, consumption expenditure contracted -13.4%. Given household support programs, consumption expenditure recovered by 15.6% in 2021 to settle at .7% in 3023.

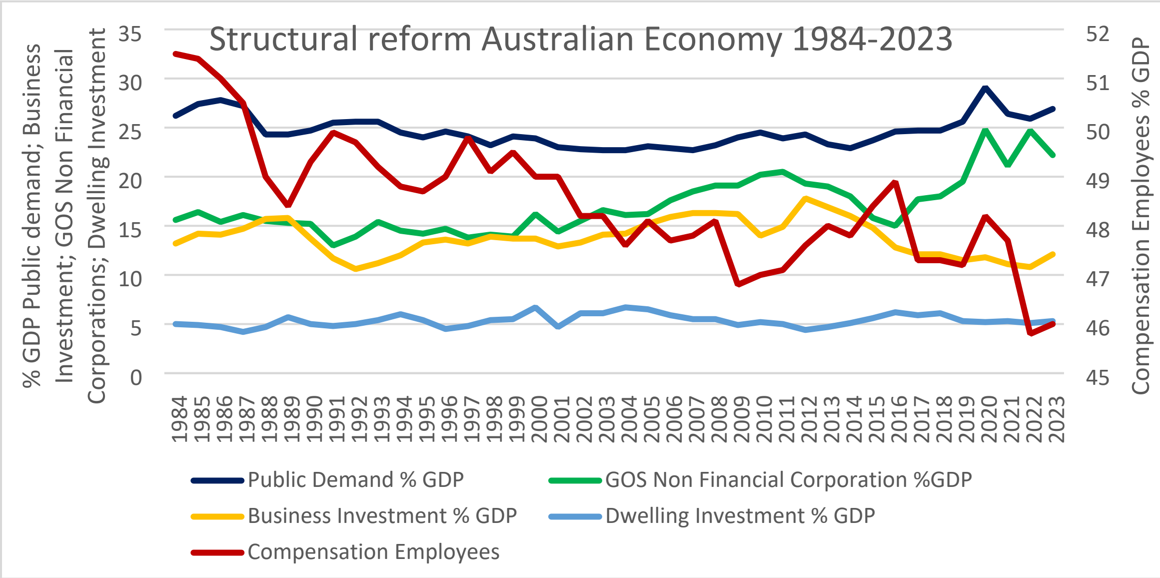
Monetary response to the COVID pandemic and international supply dislocation indicates that supply side monetary policy once again has nothing to offer in terms of economic management. Media coverage over Christmas 2023 of unprecedented numbers of people seeking help and assistance from various charities should sharpen the contemporary debate and bring focus upon the morality of contemporary monetary policy, and macroeconomic policy in general.

A contemporary public debate cannot continue to focus upon environmental and other social policy issues whilst ignoring the plight of a growing percentage of low to middle income groups struggling to provide for themselves and families. Such a debate simply reinforces the neoclassical assertion that virtue and self-interest are indivisible. The reality disclosed in the 2023 Christmas need for charity to support an increasing percentage of low-income workers contradicts this philosophical assertion of national interest being bound up in self-interest and virtue. Contemporary economics is exposed as being all about the more there is of mine the less there is of yours

5 Structural Reform & Sectoral Change

Supply side economics was introduced into Australia as Thatcherism by the Hawke Government in 1983. The objective was to reform a supposedly protection bound economy. Successive governments of all persuasions have continued supply side economics without questioning impacts upon different groups in society. The objective of supply side economics was to withdraw government intervention in the economy and let free markets rule. Chart 4 shows empirically the outcome of supply side reform of the economy.

Chart 4



Compiled from RBA Statistical Tables online Table H2 Demand and Income

The change in sectoral contributions to GDPr is statistically presented in Chart 4. Compensation of employees fell from 51.5% in 1984 to 46% in 2023.Gross operating surplus of non-financial corporations has risen from 15.6% in 1984 to peak at 24.8% in 2020. Government demand has remained relatively constant. Business investment has declined from a peak of 17.8% in 2012 to 10.8% in 2023. Meanwhile dwelling investment has risen marginally from 5% in 1984 to 5.3% in 2023.

Chart 4 identifies structural change. There can be no mistake that structural reform has been substantial. The table below sets out the sectoral percentage change.

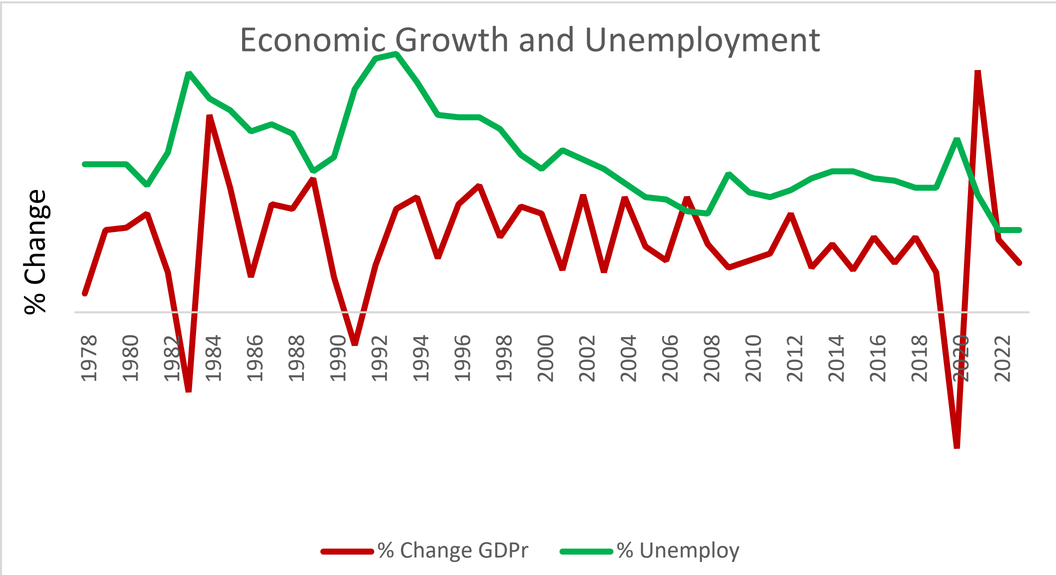
<u>% Sectoral Change Australian Economy 1984 – 2023</u>

Sector	% Change
Public Demand	2.7%
Business Investment	-8.3%
Compensation employees	-10.7%
GOS Non-Financial Corporation's	42.3%
Dwelling Investment	6%

The significant changes are in Compensation of Employees, Business Investment, and Gross Operating Surplus of Non-Financial Corporations. Some further commentary on these sectors becomes important. Whilst Business

Investment contracted -8.3% from 1984 to 2023. The real story is that business investment had been rising to peak at 17.8% in 2012. From 2012 to 2023, Business Investment contracted from 17.8% to 10.8% in 2022 which is a 39.3% contraction. In terms of Keynesian economics, such a collapse in business investment would have spelt crisis. Yet contemporary commentators have nothing to say.

Chart 5



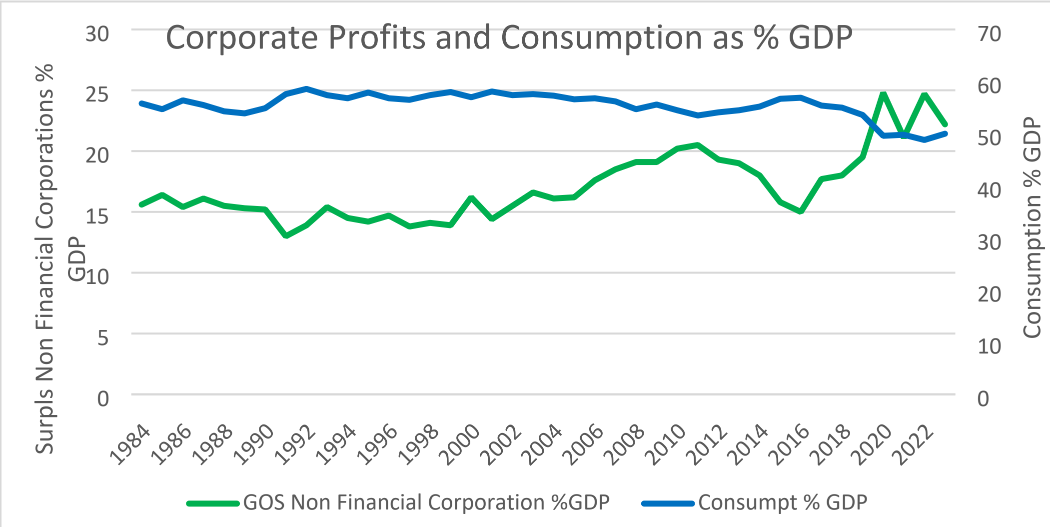
Compiled from RBA Statistical tables online Tables H1 and H5

Chart 5 shows empirically the downturn in GDP from 2012 onwards. It also shows rising unemployment from 2012. Yet we have the strange statistical evidence of a collapse in the economy following COVID and supply dislocations from 2019 to 2020 of -5.8%; but somehow the economy recovers and by 2023 unemployment is at an historic low. Clearly, serious questions hang over labour force data collection and analysis.

The other strange result is Compensation of Employees and unemployment. Graphically Compensation of Employees falls -10.7% between 2016 and 2023. That short period is shown to have redistributed 6% of GDP from labour to the wider economy. Yet we see from Chart 5 that unemployment began to fall from 2015. One way this could happen is for workers to hold multiple low paid jobs which then bolster the Labour force participation rate. But it is the redistribution of income, wealth, and political power that should concern economic commentators.

The other significant shift in sectoral contribution to GDP is by Non-Financial Corporations. Their Gross Operating Surplus increases between 1984 to 2023 by 58.3% from 15.6% to 24.7% of GDP. That is indisputably a significant shift in both economic and political power that benefits the Non- Financial Corporate Sector.

Chart 6



Compiled from RBA Statistical Tables online Table H2 Demand and Income

Chart 6 tracks empirically an implicit redistribution of GDP share between Gross Operating Surplus of Non-Financial Corporations and Consumption as a percentage of GDP. The Gross Operating Surplus curve begins its sectoral increase from 2001. From then on, the rising fortunes of the non-financial sector appear to affect consumption as a percentage of GDP. Consumption expenditure is an important economic variable which features in both Keynesian and classical/ neoclassical theories. Indeed, credited to the Neoclassical School is the underconsumption theory under which consumption expenditure becomes the critical variable of economic stability. The under-consumptionists believed that declining consumption underwrote economic dislocation. Their solution was to stimulate consumption expenditure which then flowed through to lift investment and employment- very similar to the Governments COVID response.

6 Conclusions

6.1 Issues with Monetary Policy

Contemporary political commentary appears little more than ill-informed ideology. As the RBA has been responsible for two major arms of macroeconomic policy since 1993 i.e external balance and applied monetary policy, the performance of that institution becomes questionable.

Criticism of the RBA should be about its move to the supply side/ monetarism synthesis and its reliance upon economic philosophies of monetarism and general equilibrium theory. This paper has discussed the short comings of supply side monetary policy. Empirical discussion points to supply side monetary theory meeting the definition of ideology rather than sound economics.

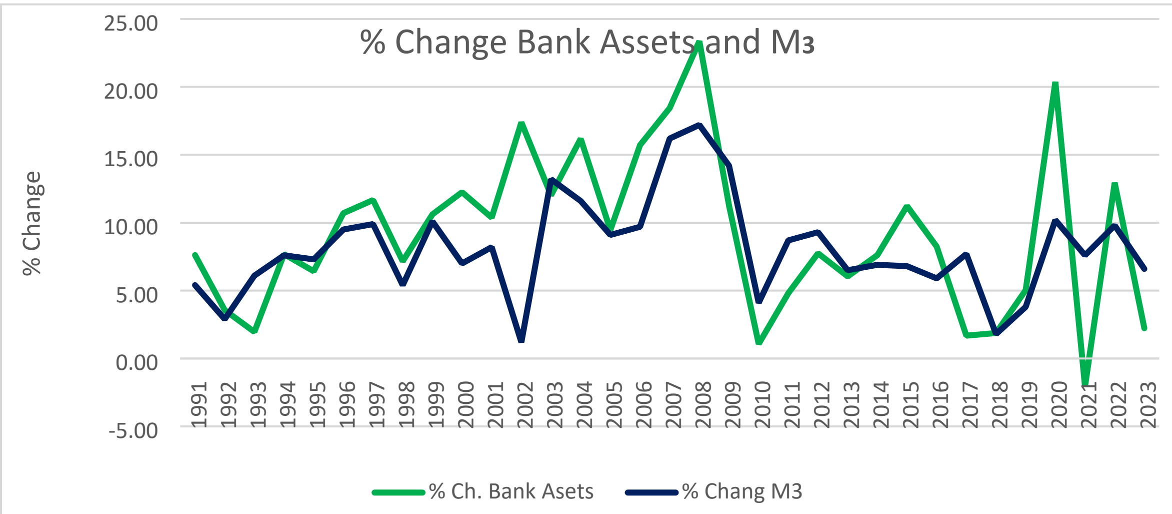
Their official view infers that inflation is caused by tight employment holding the actual unemployment rate below NAIRU. Monetary policy therefore needs to adjust actual unemployment to equal NAIRU. Such a policy direction assumes that inflationary expectations will be brought into line with the target range of 2% - 3% over the set time frame. Empirical evidence provided in this discussion challenges that view.

However, empirical analysis challenges the very basis of the RBA's philosophical beliefs. Following the assumption of an endogenous money supply in 1988, bank credit has determined the domestic money supply. The traditional monetarist belief was abandoned that monetary phenomena was responsible for inflation.

Charts 5& 6 illustrate how bank credit creation influences domestic inflation.

Chart 5 provides empirical evidence of change in bank assets and the money supply measured as M_3. Chart 6 empirically analyses the money Supply M_3 and the CPI

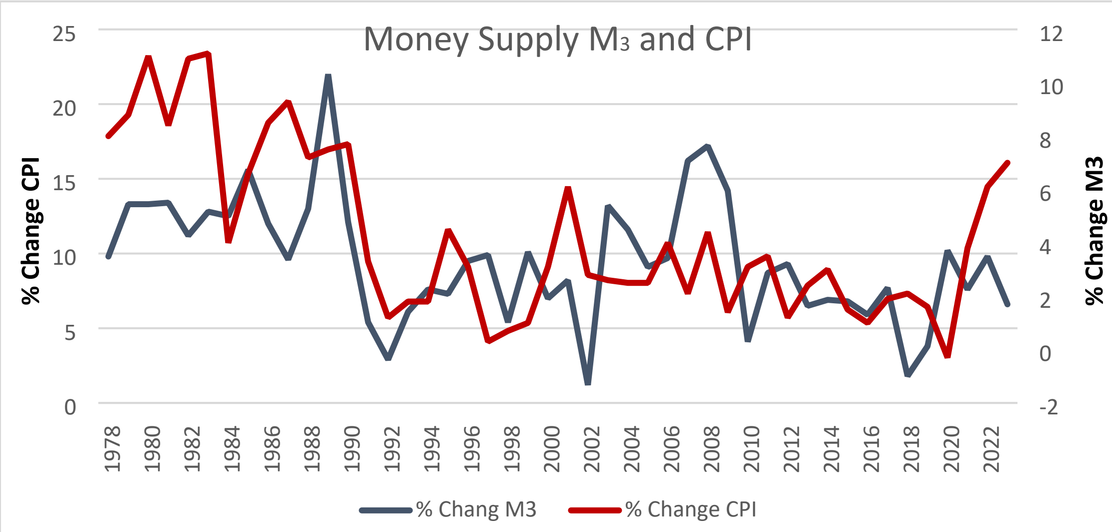
Chart 5



Compiled from RBA Statistical Tables online; Table B1 Assets Financial Institutions and table D1 Growth in Financial Aggregates

Bank assets provide raw expansion of DCE (Domestic Credit Creation) component of the domestic money supply. In the actual world, bank creation of credit nets out as mortgages exhaust, new lending occurs; and some mortgages are only partially drawn down. The net figure that emerges reflects the actual level of the money supply at any moment in time.

Chart 6



Compiled from RBA Statistical Tables online: Table D1 Growth in Selected Financial Aggregates and Table G1 Consumer Price Inflation

Chart 6 indicates a strong linear relationship between the M3 curve and the CPI curve. Inflation is a monetary phenomenon. In other words, too few goods available for the volume of money. The behaviour of both curves debunks of the argument that contemporary inflation is caused by actual unemployment out of sync with NAIRU.

6.2 Issues with Distribution Income and Wealth

The other significant issue discussed in section 3 is the redistribution of GDP share under the supply side/ monetarist synthesis. The dominant beneficiary has been Gross Operating Surplus of Non-Financial Corporations. That increase has been at the expense of Business Investment, and Compensation of Employees. The obvious question becomes: What happens to the gross operating surplus.

- Does it flow back into the Australian economy through share holder distribution?

- Is it transferred to overseas shareholders?
- Is it reinvested back into Australian economy in some form?

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The decline in business investment is most concerning. In Keynesian economics, business investment is the critical variable for stability of the economy. To counter economic dislocation, business investment becomes the focus of economic policy to maintain the economy at full employment output.

The decline in Compensation of Employees impacts upon the stability of household disposable income and hence consumption as a percentage of GDP. The size of the redistribution from labour to the corporate sector should ring alarm bells in political circles. The failure to do so reflects the dominance of ideology over serious economics that prevails under supply side reforms.

The change in economic outcomes that favoured gross operating surplus of Non-Financial Institutions has significance beyond GDP percentage change. It restructures change in both political and economic power within the social fabric of society. That appears to be overlooked in contemporary economic debate which asserts that as long as economic growth is positive the economy is doing well. That myth cannot withstand the reality of the transfer of economic and political power to corporate Australia. The only solution to this problem is to have strong Trade Practices Legislation which incorporates sensible divestiture powers. Lessons need to be learned from the abandonment of divestiture powers that were included in the 1974 Trade Practices Legislation.

Finally, the problems discussed in this paper reflect directly upon the underlying economic philosophies that structure the supply side/ monetarist synthesis which replaced the post War economics of J. M. Keynes. The performance of the replacement economic philosophies does not withstand analysis. There needs to be a national forum of significance that analyses the growing maldistribution of income and wealth; and the persistence with an economic philosophy that openly proclaims:

"Since wealth effects are a key element of monetary transmission mechanism, any cooling of economic activity required the asset price inflation be brought under control".

The RBA proclaimed this in a research paper back in 1992; but by 2023, the evidence mounts that it has been unable to deal with the central problem identified as asset inflation. Moreover, asset inflation appears to have been expunged from the economics nomenclature. That makes for a very imbalanced monetary policy arm.

- The Australian Government needs to reclaim control of economic policy and use its Constitutional Powers to manage the economy in the interest of the Australian people.

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[i] Robinson Joan, *Economic Philosophy*, Penguin Books,1976, p. 122
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[iv] Lloyd P.J., Chapter 5, *Protection Policy, From Surveys Australian Economics*, Ed. F.H. Gruen, George Allen & Unwin,1978, p. 271
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[vi] Blundell-Wignell Adrian and Bullock Michelle, *2. Asset price Inflation, Borrowing and the Business Cycle*, RDP 9212, RBA online.
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